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TREASURY FOR INTERNATIONAL AFFAIRS - CHRIS PLANTIER

E.O. 12958: DECL: 03/13/2011
TAGS: EFIN TU
SUBJECT: ERDOGAN'S RISKY ECONOMIC DECISIONS COINCIDE WITH EMERGING MARKET SELL-OFF

REF: A. ANKARA 40

¶B. ANKARA 346
¶C. ANKARA 592

Classified By: Economic Counselor Thomas Goldberger for reasons 1.4(b) and (d).

This cable has been coordinated with Congen Istanbul.

¶1. (SBU) Under pressure from exporters, the GOT announced a Value-Added Tax rate cut for the textile sector without consulting the IMF and in violation of its agreement with the Fund. At the same time, the GOT has decided not to renew the mandate of the respected Central Bank Governor. These two market-unfriendly decisions came just in time for a major sell-off in emerging markets that hit Turkey harder than most. Though the IMF program is still salvagable, the GOT is taking a risk, particularly if the EM sell-off resumes. End Summary.

VAT Rate Cut Violates IMF Commitment

¶2. (SBU) Prime Minister Erdogan announced on March 7 that the GOT would reduce the Value-Added Tax rate on textiles and leather goods from 18 to 8 percent, effective immediately. The announcement came after a drumbeat of complaints from exporters, particularly from the textile and leather goods sectors, that the government needed to do something to help them compete in global markets. Their complaints included what they perceive to be an overvalued exchange rate, high taxes, and high energy costs. Though a rate cut would help the stressed textile and leather goods companies with their domestic sales, it would not help their exports since they can claim a VAT rebate on exports. Consequently, textile company executives' reaction to the rate cut was mixed, and in some cases negative.

¶3. (SBU) Two years ago, the GOT, led by the Tax Administration, pushed very hard for a VAT rate cut on textiles. At the time, the IMF rejected the idea. The GOT argued then, as it does now, that with so much of the textile sector operating in the unregistered economy, lowering VAT rates could help increase tax compliance. As the Deputy IMF Resrep recently reminded us, cutting rates in a single sector goes against the grain of the economic program's medium-term strategy, which focuses on reducing exemptions and loopholes and broadening the tax base before moving to cut rates. Nor do the IMF's fiscal experts find the increased compliance argument compelling, not wishing to take the risk that rates would be cut with no improvement in compliance.

¶4. (C) Perhaps worst of all was the complete absence of consultation with the IMF--an explicit contravention of the IMF Letter of Intent. The Deputy Resrep told us the Fund had hoped the GOT would hang tough, based on some earlier public statements and the IMF's strong message when Erdogan had blind-sided them with populist measures in earlier years. In the final run-up to the Council of Ministers' decision, senior Fund executives had tried unsuccessfully to call Erdogan and hd sent a letter, but to no avail.

¶5. (C) I what may portend a shift in the balance of power within the GOT between economic reformers ad populists, the Deputy Resrep reported the relative weakness of the reformers at a meeting of the Economic Coordination Council. Populist Trade Minister Tuzmen and Industry Minister Coskun reportedly pushed hard for the measure, and neither Finance Minister Unakitan nor Deputy Prime Minister Sener resisted. With Economy Minister Babacan absent, it fell to lower-ranking ~Treasury Under Secretary Canakci to try to uphold the commitment to the IMF, but he was overruled.

¶6. (C) The GOT has since committed to the IMF that any fiscal cost of the measure will be made up for with compensating measures. Ozgur Demirkol, the Turkish Treasury official coordinating the Fund program, told us he doubts the measure is sufficiently damaging to derail the entire program. On the other hand, the GOT's action will only reinforce the Fund's determination not to resume negotiations on the third review until the social security parametric reform -- still bottled up in committeee -- is passed by parliament.

Change at Central Bank Confirmed

¶7. (SBU) At the same time the GOT took the risk of alienating the IMF, it seems to have made up its mind not to renew the mandate of respected Central Bank Governor Serdengecti. Though few local observers had expected the GOT to keep Serdengecti on, and the GOT continues to deny it has a made a choice of a new Governor, it is now clear that it will not be Serdengecti, since March 13 is his final day in office. Until the GOT finally announces Serdengecti's replacement one of the Central Bank Vice Governors will be acting Governor. Press is reporting the GOT has settled on Vice-Governor Erdem Basci to be the new Governor. Though Basci is a well-regarded academic economist and for the past two years has worked well with Governor Serdengecti, at 40, he is young. More importantly, being close to the AK Party Government, there is some question whether he will be able to take an independent line. Though markets are likely to breathe a sigh of relief when the GOT confirms it has chosen Basci, as with the VAT decision, the GOT has taken a bit of a risk, rather than pursuing the most prudent, market-friendly course.

Emerging Market Sell-Off Hits Turkish Markets

¶8. (SBU) The GOT announced the VAT decision just in time for an across-the-board sell-off in emerging markets, sparked by increased expectations of tighter monetary policy and higher interest rates in the U.S., Europe and Japan. From March 7 through 9, the Istanbul stock exchange lost 8% of its value, the lira weakened from 1.3069 to 1.3426 to the dollar and the yield on the benchmark government bond rose from 13.41 % to 13.52%. The sell-off hit all emerging markets hard, but Turkey fell more than most,. The Turkish stock market fell more than that of Brazil, for example, a country with which it is frequently compared. Though anlaysts put most of the blame on global conditions, there was an absence of positive local news and several market-unfriendly local stories. Among these were reports the Prime Minister had made comments about monetary policy, government-military tensions, critical comments by former Economy Minister Kemal Dervis, the VAT rate cut and the Central Bank Governor uncertainty, all of

which may have played a role in Turkish markets falling farther than most.

Comment

¶9. (SBU) The sell-off had subsided by Friday, March 10. The markets rallied on Monday, March 13 driven by a broader emerging market rally and the news that Dogan Holdings was selling a minority stake in petroleum product retailer Petrol Ofisi to Austria's OMV for over $1 billion. However, a number of Istanbul analysts believe the correction is not over, and that it could resume again, if interest rates keep rising in the world's largest economies. Given that backdrop, and the real risk of problems on the EU front with the Cyprus issue, it is striking that the GOT decided to take some risk for short-term political gain on the VAT cut and the Central Bank Governorship. It's too soon to say a pattern has been established, but reform fatigue and complacency on economic policy, combined with the approaching election season may spell trouble for continuing economic reform, and augur more market volatility in coming months. The irony is that the government's action has embittered not just the IMF but the measure's intended beneficiaries: most in the textile industry have argued that the action is too little, too late, and does nothing to address the sector's underlying problems.

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